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There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as a result of the voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved.

Human Action, *A Treatise of Economics,* Ludwig von Mises
Contemporary Books, Inc. Chicago

THE GREATEST THREAT

Strange things have been happening in the past few months in Mr. Greenspan's realm of money and credit. A prior prolonged and pronounced slowdown in broad money growth abruptly turned into a virtual money explosion in the last four months of 1999, taking the stock market with it. M3 wildly inflated by $340 billion, as against a moderate increase in the preceding eight months by a little more than $200 billion. Something or somebody had apparently raced to the rescue of the stock market which, at the time, had been floundering. Remember, it was also the time when the European central banks boosted the gold price with their agreement to freeze their cheap gold loans at existing levels.

As for movements of global stock markets in the new millennium, there is little new to report or to comment. The familiar pattern of last year is still in full force: a few stocks of the fanciful part of the "new economy" are going forever crazier, whereas the stocks of the much greater part of the "old economy" are languishing or falling. Wall Street is by no means alone in this respect. The shares of Deutsche Telekom have soared 60% over the past three months on the wings of a profit collapse by 45%.

MORE GREENSPAN DOUBLSPEAK

Nor has there been any visible change in Mr. Greenspan's customary "doublespeak." In a speech before the Economic Club of New York, Mr. Greenspan once again warned against excesses in the markets and the economy, while comforting everybody with the promise to maintain his gradualist approach to hiking rates. Although leaving little doubt about a rate hike at the Fed's next policy meeting, he instantly softened the warning with the remark that sharper increases are not on tap. Given a general conviction in the markets that it would essentially need a more drastic tightening by the Fed to halt the stock market boom, he certainly did more to stimulate further excesses than to restrain them.

In the same vein, he left no doubt about his almost religiously optimistic belief in the economic miracles that the new information technology is doing to the American economy. Yet it caught some attention that for the first time ever he expressed concern about dangerous "imbalances" in the economy and the financial system. Quoting from the speech:

> *When we look back at the 1990s from the perspective of say 2010, the nature of the forces currently in train will presumably have become clearer. We may conceivably conclude from that the vantage point that, at the turn of the millennium, the American economy was experiencing a once-in-a-century acceleration of innovation, which propelled forward productivity, output, corporate profits and stock prices at a pace not seen in generations, if ever.*

Alternatively, that 2010 retrospective might well conclude that a good deal of what we are currently experiencing was just one of the many euphoric speculative bubbles that have dotted human history....

On the one hand, the evidence of dramatic innovations (veritable shifts in the tectonic plates of technology) has moved far beyond mere conjecture. On the other, these extraordinary achievements continue to be bedeviled by concerns that the so-called New Economy is spurring imbalances that at some point will abruptly adjust, bringing the economic expansion, its euphoria and wealth creation to a debilitating halt.

Mr. Greenspan's speech vividly reminds us of an old joke about economists. A firm had advertised for a one-armed economist. When such a specimen applied, he asked the manager why they had posed this odd condition. The answer: "We wanted to guard against the many economists who habitually say 'on the one hand' and 'on the other hand.'"

THE EARMARK OF A BUBBLE ECONOMY

Interestingly, some of the keener and most respected Fed watchers have also noted that for the first time ever Mr. Greenspan mentioned rising "imbalances" such as demand excesses spurred by wealth effects from both the stock and real estate markets, a shrinking labor pool, accelerating wages, unsustainable trade deficits, and excessive borrowings and insufficient savings.

One prominent Fed watcher stated, it was now clear that Greenspan effectively knows all is not well. Former Federal Reserve member Lyle Gramley said on CNBC that if stock market excesses are not dampened "interest rates can go up a long, long way" and that "there are real problems ahead." Gramley also made the cogent point that the inflation in this cycle is not in the CPI, but has instead manifested itself in the stock market, the exploding trade deficit and other unsustainable maladjustments.

At any rate, the all-important role of the wealth effects in powering U.S. economic growth is no longer disputed. According to an estimate presented by Mr.Greenspan himself in his speech in New York, this effect is worth approximately one percentage point of real GDP growth accounting for fully 25% of total U.S. economic growth over the past three years. Conveniently, Mr. Greenspan forgot to mention that this is precisely what qualifies an economy as a "bubble economy."

What, exactly, did the extraordinary bull run of the stock market, in particular during the last few years, reflect? Definitely not the profit miracle that the bulls permanently implore. Between its trough in 1981 and the end of last year, the value of the S&P composite index, deflated by consumer prices, rose by 570%. Yet the underlying real earnings of the companies (equally deflated) included in the index increased by a mere 61%. Stock prices, in other words, rose nine times as fast as corporate earnings. While corporate earnings have grown, their increase has been unexceptional. Meanwhile, the price-earnings ratio quadrupled from eight times to 32 times earnings. In lockstep, the ratio of the stock market's value to GDP jumped from a 60-year average of 50% to today's 150%.

Seemingly, investors could not have cared less about lagging profits and collapsing dividend yields. While this bull market started in the early 1980s, it was in 1995 that the rise in stock prices went truly parabolic. Ironically, this acceleration coincided precisely with a distinct slowdown in profit growth, as measured in the national income and product account. Since 1997, the stratospheric travel of the stock market has corresponded with virtual profit stagnancy.

Corporate America's actual, poor profit performance is the one thing that makes it more and more difficult

to understand the stock market's bullishness. What's worse, last year it came under additional assault from sharply rising bond yields, increasing in the course of the year by more than 170 basis points. That was a rise of 30%. For U.S. bonds, it was the worst year in decades.

ANOTHER BANNER YEAR FOR STOCKS

Yet, look at the further eruption of the stock indexes in the course of 1999. For the year, the Dow gained 25%, the S&P 500 20%, the Nasdaq composite 86%, the S&P 100 31%, the Wilshire 5000 22%, the Nasdaq 100 102%, the Nasdaq Telecommunications index 103%, the Amex composite 27%, the Amex Broker/Dealer index 62%, the Russell 2000 20%, the Interactive Week Internet index 189% and the Street.com Internet index 184%. IPOs, largely Internet related, gained an average 187% from their offering price. It was clearly the year of the high tech stocks. At the height of Japan's bubble in late 1989, the Nikkei market had an average P/E ratio near 80. The year-end 1999 Nasdaq P/E ratio is estimated to have been around 200. The Dow Utility average lost 9%, and the Dow Transports dropped 5.5%. Long-term bonds had a negative return of 11%.

Throughout the world, it was very much the same bright picture of a powerful and relentless bull market in stocks. In Europe, the German Dax index surged 39%, the French CAC 40 51%. In Eastern Europe, Poland had a gain of 41% in its stock index, Hungary 40%, Ukraine 80%, Russia 300 %. In Asia, the Japanese Nikkei 225 jumped 37%, while the Nikkei 500 soared 82%. Led by exorbitant gains in technology shares, Japan's Jasdaq stock index rocketed 244%. In Korea, the stock index increased 83%, in Singapore 78%, Malaysia 39%, Thailand 35% and Indonesia 70%. To be sure, it was another stellar year for global stock markets.

Was it really? Assessing these fabulous numbers, it needs two big caveats: first, these vertical increases in global stock indexes did follow a prior steep decline in the wake of the Asian crisis; and second, the upward movements of the indexes in most countries have actually masked a steady decline in the great majority of stocks, as measured in America by the advance-decline ratio. According to reports, three-quarters of the stocks on the NYSE and the Nasdaq continue to head south. This of course is, consistent with the pronounced rise in long-term rates and the sharp declines in leading traditional sectors such as utilities and transportation.

It all boils down to a progressively widening two-tier market. But while the accumulated wealth gains from rising stock prices are enormous and big enough to maintain a massive stimulus to spending, they are currently shrinking. However, the rising indexes, though not fully reflective of development in the markets, keep bullish publicity and sentiment in full force. Nevertheless, what the continuous slide in the advance-decline line essentially signals is a downshift in market liquidity.

What makes this downshift in market liquidity rather remarkable is the fact that it is happening against the background of rampant credit creation. Apparently, it has diminishing effects on economic activity and the financial markets. Putting it in reverse: In order to move the economy and the markets, it requires ever bigger credit injections. The parallel with the drug addict is manifest. Over the last few years, as the following table shows, a phenomenal

U.S. CREDIT GROWTH BY SECTOR, IN $ BILLION

		FEDERAL GOVERNMENT	TOTAL NONFEDERAL	CONSUMER	BUSINESS	FINANCIAL SECTOR	TOTAL	GDP GROWTH
1996		145.0	600.3	354.0	253.2	548.9	1,294.2	412.7
1997		23.1	764.0	327.3	380.6	652.2	1,439.3	487.5
1998		-52.6	1,076.7	471.9	524.5	1,068.8	2,092.9	459.2
1999	- Q1	-75.2	1,363.3	556.4	719.5	1,214.2	2,577.5	00.4*
	Q2	-112.2	998.7	517.1	445.9	1,042.9	1,929.4	294.4*
	Q3	-83.1	1,214.1	566.0	595.3	1,046.5	2,177.5	596.0*

Source: Flows of Funds Accounts, Federal Reserve. * at annualized rates

gap has opened up in the United States between credit growth and GDP growth. Overall credit growth by fully 100% since 1996 compares with overall nominal GDP growth of about 20-30% during this period.

The principal purpose of increases in interest rates is to restrain credit as the chief source of excess demand. This table shows an unbridled, overabundant supply of credit in the United States during these years, measured both in absolute numbers and in comparison to GDP growth. There is no trace of the slightest monetary tightening in these numbers. With its extremely cautious rate hikes, the Fed may well have kept short-term rates artificially low. Businesses and households apparently continue to perceive that the returns on the investments financed with the borrowed money still exceed their higher costs.

There is nothing new about speculative manias in asset markets. The infallible and most visible earmark of such bubbles is credit creation in excess of economic activity, as measured by nominal GDP growth. Nevertheless, **there is something unique and unprecedented about the present U.S. bubble: the phenomenal magnitude of the credit excesses that have effectively materialized.**

Inflation, to classical economists, is the undue increase in the supply of credit above the level that is supported by current savings. What the above table reveals can be described as credit creation being completely out of control in relation to economic activity and available domestic savings. In the bubble years of the 1920s, the credit-to-GDP ratio (measuring credit growth versus GDP growth) was at its peak, a little over 2-to-1. Today, it is well over 4-to-1. For each dollar added to the GDP (at current prices), there have lately been 4.5 of additional debt. **By this measure, the U.S. stock market's bull run does not only rank as a bubble, but as the biggest and the worst of its kind in history.**

DEFEATING KONDRATIEFF DEFLATION

Bubbles and booms often continue much longer than anyone thinks possible. Nevertheless, all bubbles eventually burst with a vengeance, and the current one will not be any exception. Unfortunately, nothing else can safely be said in advance. Which brings us to the three big concerns on which rides the fate of the world financial markets and the world economy for years to come: *first,* the potentially surest and greatest threat to the bubble; *second,* the probable timing of its burst; and *third,* the potential severity of the economic and financial aftermath.

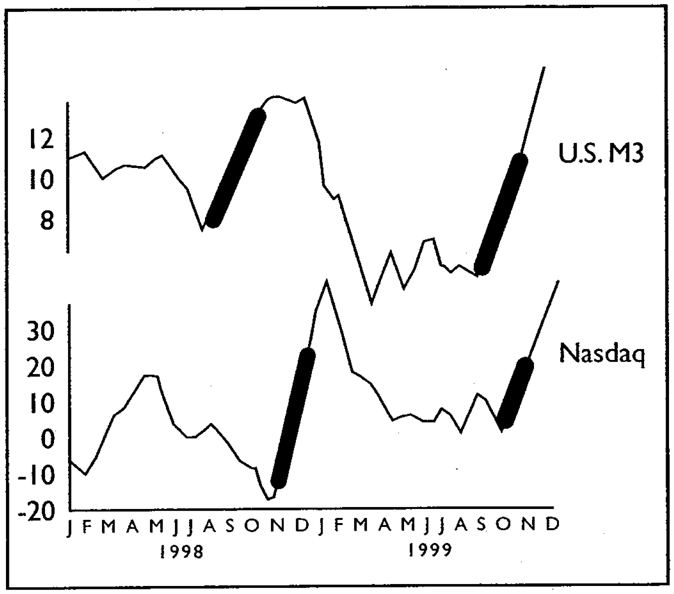
From most comments on these questions we gather that the consensus fears but one single, potential threat to the U.S. stock market: rising interest rates, pushed up either because the overheating economy will sooner or later force the Fed to an effective tightening of its reins or, else, that growing concern about inflation will successively jack up bond yields to levels that do the tightening for the Fed.

As a matter of fact, we have always looked somewhat askance at Mr. Greenspan since he shocked us in the 1970s with a statement that stock market gains ought to be regarded and treated as savings. What's more, a friend of ours now living in London told us sometime ago of an astounding conversation he had in the early 1970s. At a lunch with Mr. Greenspan (when he ran his own economic advisory service), they discussed gold and the Kondratieff Cycles. Mr. Greenspan stated that he would love to be head of the Fed when the Kondratieff Cycle was due to end in the late 1980s. He was quite sure that he could overcome the deflationary impact of the cycle by injecting sufficient credit into the system to offset deflation. He ended the conversation by saying that should he fail to achieve his objective, there was a chance that when the cycle did end, the resulting Depression would be by far the biggest the world has ever known.

He did become head of the Fed. The amount of credit he has pumped into the system has been on a scale never before seen in economic history. So far, he has been successful. In the end, nevertheless, his final statement will prove correct.

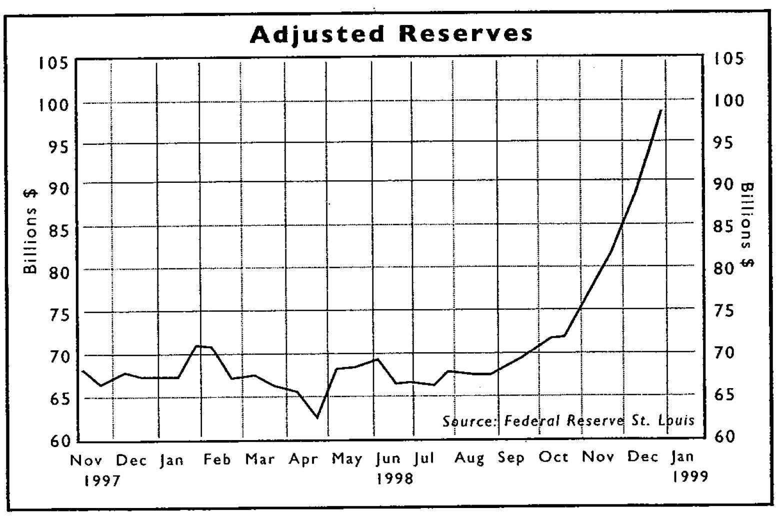
EASING IN DISGUISE

We have the impression that Mr. Greenspan is, after all, eager to prove his case. Conspicuously, his rate hikes have progressively trailed the rise in longer-term market yields. Their increase since the start of 1999 by more than 170 basis points contrasts with a rise in the Fed's federal funds rate by merely 75 basis points. A widening yield curve tends to indicate monetary looseness. Past experience, in fact, suggests that interest rates pose their greatest threat to the markets when short-term rates exceed long-term rates, thus inverting the yield curve. Far from implementing at least a narrowing of the yield curve, Mr. Greenspan has taken care that it widens substantially.



Not only that, as already mentioned, the last months of 1999 saw a new burst in U.S. broad money growth, with M3 shooting up at an annual rate of 18.5%. It was the fastest pace of monetary expansion in more than a decade. As M3 is overwhelmingly the by-product of credit extended by the banks and other depository institutions, it essentially implies a corresponding record-breaking expansion of bank lending.

Considering both the strength and the duration of this burst in money and credit creation, it certainly played a role in stoking the late-year buying frenzy in the stock market. But such a monetary explosion does not happen just by accident. Given the earlier worries about the Y2K "bug," some restraint in new lending would, in effect, have looked rather more probable than this extraordinary lending boom. What or who did, then, trigger it? As to be expected, one position in the Fed's balance sheet gives the answer: adjusted reserves.



Officially, the reserve accommodation in the last quarter of 1999 was Y2K-related. But while the "bug" proved a non-event, the Fed's precautionary measure translated into a very big money and credit effect in the banking system. In fact, the Fed had put a Special Liquidity Facility at the disposal of the banks which apparently was so generous that it invited credit expansion. Collateral requirements had been drastically loosened and existing restrictions on the use and duration of the Fed advances were completely lifted.

But most important for the sweeping effect of the facility on the credit system may well have been its stipulated long duration: from Oct. 1, 1999 to April 7, 2000, stretching thus over more than six months. Considering the actual money and credit explosion that developed, it rather looks like drastic monetary easing under the cover of alleged measures against the Y2K "bug." Whether or not that big effect was intended is the only question we have. It's the long duration of this extremely generous liquidity facility that has aroused our suspicion.

BIG HIDDEN LEVERAGE

Yet, we have long realized that bank credit is in reality only a small and shrinking part of the prodigious output of the U.S. credit machine. Most of the new credit is now manufactured outside the banking system (by the securities markets and by the so-called non-bank lenders, of which there are three major groups: so-called Government-Sponsored Enterprises, Federally Related Mortgage Pools and Issuers of Asset-Backed Securities: These three groups account for the bulk of the borrowing and lending by the "financial sector" (See table on page 4). Among them are Freddie Mac and Fanny Mae, whose frantic borrowing and lending activity has occupied us several times in the past.

Until the mid-1980s, the borrowing and lending activity of these "non-bank intermediaries" had played a negligible role. Their great outburst started in 1993/94. Since then, their rate of expansion has about quadrupled to more than one trillion dollars annually which virtually equals or even exceeds total consumer and business borrowing. With this stunning expansion of their financing activity, they have essentially developed into the leading propagators of the American credit bubble. But what, really, is the essence of their activity? In brief: they provide the system with virtually unlimited financial leverage.

Instead of lending directly to consumers or businesses, they securitize or buy all kinds of securitized loans, in particular mortgages, from the original lenders. In so far, it may seem that their activity involves no repercussion in the economy. Nor, by the way, does the borrowing and lending of these intermediaries (unlike bank credit) increase the money supply. For this and other reasons, their runaway expansion is attracting very little or no attention at all. So, what is the problem?

As said earlier, these institutions provide virtually unlimited leverage to the financial system. They do so by taking over loans from banks and other lenders. As the balance sheets of these lenders are correspondingly reduced, they gain new lending power. Evidently, this increases the credit-creating power of the financial system as a whole. In fact, any limiting factor to credit creation in America has been abolished because these non-bank intermediaries do not depend on the fed for their liquidity reserves. Their effective liquidity reserve is the vast, total money supply which they tap through the money market to finance their holdings of credit paper. In the final analysis, their activity boils down to a *more intensive use of bank deposits in the existing money supply.* But we stress the decisive point most emphatically: For the effect of credit on the economy or the financial markets, it does not at all matter whether it comes from banks, non-banks or the securities markets. The one and only thing that makes all the difference from a macro-perspective are available savings.

Considering the incredible expansion of these institutions during the past years, it stands to reason that in addition to boosting the overall lending power of America's financial system, they have also materially helped to keep interest rates at lower levels than market forces implied. In the fourth quarter of 1999, by the way, Freddie Mac and Fannie Mae combined expanded their assets by $46 billion, or 25%, and by $155 billion, or 19%, during the year.

A PERVASIVE DIFFERENCE

Back to our initial concern of the greatest potential threat to U.S. equities, bonds and the whole bubble economy. In late 1989, the governor of the Japanese central bank, Mieno, decided to puncture the land and stock market bubble in his country by raising interest rates rather than waiting until it burst of its own accord some time later, but more violently and from even more extreme levels of overvaluation. Given low rates of consumer and producer price inflation, his great concern was with the debt explosion and structural distortions and imbalances that it was inflicting on the economy and the financial system.

As mentioned earlier, credit excesses are the most visible earmark of asset bubbles and bubble economies. By this measure, so we added, the present U.S. bubble easily ranks as the worst of its kind in history. But in the view of Mr. Greenspan, this credit expansion is harmless because consumer and producer price inflation remain well-behaved. For him and many others, this is compelling proof that the traditional link between economic growth and inflation in the U.S. economy has definitely been broken. And what else could have caused this break than the advertised new paradigm productivity miracles?

Well, for anybody willing to see, there is obviously another cause heavily at work taming U.S. domestic inflation: the ever-widening U.S. current account deficit and the strong dollar, diverting a massive and rapidly increasing part of U.S. excess demand to foreign producers. Having surged from 1.7% of GDP in the mid-1990s to a record high 3.9% by the third quarter of 1999, the deficit meanwhile adds up to almost 10% of GDP for the last four years.

So far, the markets have taken the explosive rise of the trade deficit very calmly. Few people seem to be aware that there is a crucial and most dangerous difference from the U.S. bubble in the late 1920s and also from the Japanese bubble in the 1980s. At the time of these bubbles, both countries were the world's leading creditor countries, running large current-account surpluses. Most importantly, these surpluses were the protective shield that enabled the two central banks to instantly slash their interest rates when the markets crashed and the economies slowed. In neither case did this prevent the disastrous aftermath, but the salient point to see is that with America's present extremely weak balance of payments, Mr. Greenspan will not even have the choice of rapid rate cuts. Apparently, it has yet to be realized that the state of the balance of payments makes all the difference for the freedom of monetary policy to ease under such circumstances.

This takes us to what we regard as the greatest threat not only to U.S. financial markets but to the economy and even to the world economy. It lies in the currency markets, particularly with a sharply falling value of the dollar against the euro. Oddly, this risk is rarely mentioned, and if so, it is discarded with the comforting view that the economic acceleration in the rest of the world and slower U.S. economic growth will take care of that deficit and the dollar. On the other hand, it is assumed that the U.S. economy with its new paradigm qualities will forever remain the major magnet for foreign capital.

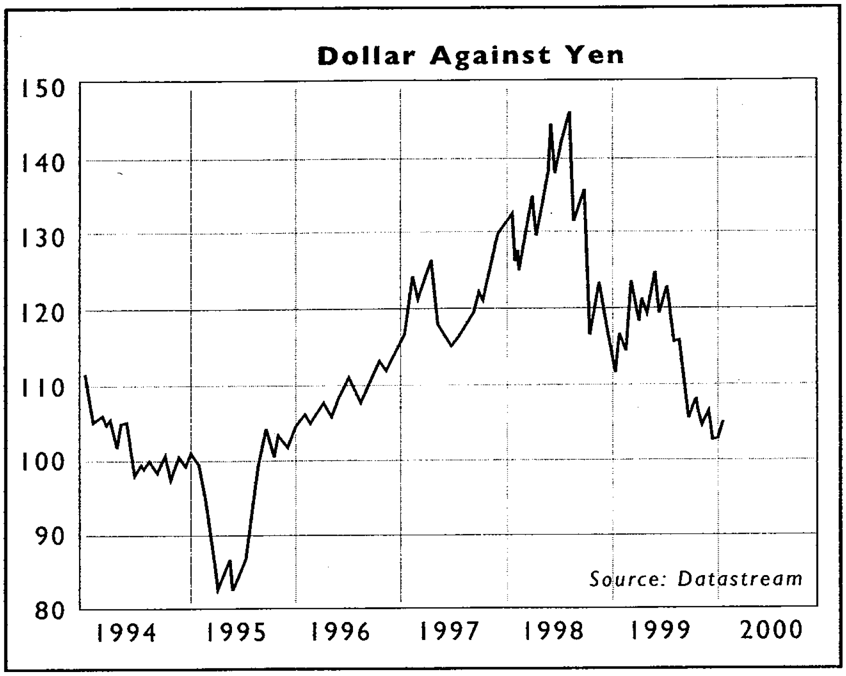
DOLLAR QUESTIONS

In October 1998, at the height of the Asian-Russian crisis, the dollar peaked against the yen at 147 yen and bottomed against the DM at DM 1.62. Despite heavy interventions by the Bank of Japan, it has since plunged against the yen by about 30%, while climbing around 17% against the DM. The conventional explanation for the strong yen is that foreign investors, attracted by corporate restructuring in Japan, have been pouring money into Japanese shares. Conversely, the weak euro is conventionally explained with a stampede of European corporations through mergers and acquisitions into the U.S. stock market.

The strength of the dollar against the euro essentially implies that U.S. capital inflows have risen even faster than the U.S. external deficit. Given this prolonged, positive experience, many economists and analysts readily conclude that this pattern must have lasting causes related to the U.S. economy's new paradigm qualities. Trying to assess the prospects for the three big currencies therefore has to start with an investigation, *first,* of the causes fueling the U.S. current-account deficit, and second, of the forces driving or pulling the U.S. capital inflows. Considering the dollar-euro rate as the all-import exchange rate for the world economy and world financial markets, we have done some further exploration to give a reasonable answer.

Principally, a trade deficit is always exactly matched, one for one, by an inflow of capital. Deficits can't arise

without being financed. Changes in one, therefore, condition corresponding changes in the other one, but it can at times be an intriguing task to determine, which of the two is the primary imbalance. To answer this question, it needs examination from case to case.



The most-cited cause of the strong dollar is the superior profitability of the U.S. new paradigm economy. It is supposed to spur the vast investment flows, in particular from Europe, into the U.S. economy. This rosy view further holds that the gaping U.S. trade deficit is by no means the unhealthy outgrowth of American borrowing and spending excesses, but the intrinsic, very healthy mirror image of these capital inflows, attracted by the U.S. economy's superior profitability. Under a system of flexible exchange rates, according to this explanation, the resulting strong currency implicitly generates the current-account deficit which makes the dollars for the foreign investors available.

To stress the key point: In this scenario, the capital inflows come first and the soaring trade deficit thereafter. The chain of causation is precisely the reverse of what is generally assumed. Happy end for the dollar, and everything else is assured by the unfailing pulling-power of the U.S. new paradigm economy on foreign capital.

Yet there is a very ugly alternative scenario. It says that the gaping trade deficit primarily accrues from the unprecedented borrowing and spending excesses that Mr. Greenspan has recklessly fueled with his overly loose monetary policy. Compelling proof of the deficit's insidious nature lies in the preposterous credit figures. Given a limited domestic supply of goods but considerable excess capacity in the rest of the world, a large and growing part of the developing domestic excess demand is spilling over to foreign producers. Hence the current-account deficit. What, on the other hand, fueled the rising tide of capital inflows was a variety of influences, but the flows through the stock market are at any rate much too small to explain the dollar's strength.

YEN VERSUS EURO

If the dollar would, indeed, derive its strength chiefly from the superior U.S. corporate profitability, it is difficult to understand why this works only against the euro, and not against the yen. In brief, the credit and bond markets are the far more important channel for these capital flows. Yet, the yen is strong against the dollar even with much lower interest rates than in Euroland. Why?

Well, the yen had a long, steep decline against the dollar behind it that lasted from mid-1995 to September 1998 when it abruptly turned around, and since then it has needed repeated, massive dollar purchases by Japan's central bank to prevent an even sharper rise of the yen.

The main reason for these wild fluctuations is commonly known: ups and downs in the infamous yen carry trade, where yen were borrowed with high leverage at near-zero interest rates and invested in high-yielding U.S. Treasuries.

Vice versa, it was the collapse of the yen carry trade that sent the yen into its upward spiral, notwithstanding the widening interest rate differential between dollar and yen. The salient point is that the carry trade play critically depends on two indispensable conditions: a stable or (even better) a weak yen, and stable or falling U.S. bond yields. When the yen shot up against the dollar in the wake of the Asian-Russian crisis and U.S. Treasury yields began to rise, it promptly backfired on the whole yen carry trade. Threatened with losses on both counts, the speculators had to unwind their positions in a hurry, selling dollars and buying yen.

With the yen carry trade dead and Japanese private capital outflows vastly insufficient to absorb the high current surplus running now at an annual rate of $120 billion, there is only one way for the yen: to go up, even against the backdrop of a high and rising yield differential between the two currencies.

What about the euro's weakness? To begin with: Here, too, the popular new paradigm story about capital flows from Europe into the U.S. economy fails to stand up to examination. It simply is the popular bullish opinion. The biggest single component among U.S. capital inflows in 1998 and the first half of 1999 (later data are not available), were foreign purchases of U.S. bonds "other than U.S. Treasury securities," meaning chiefly corporate bonds. True, European purchases of U.S. stocks also surged to record levels, in particular in the wake of mergers and acquisitions, but various large investments were accomplished by exchanging stock, leaving the currencies therefore unaffected.

A recent report about international bond issuance, we think, pinpointed the true, overriding cause of the euro's weakness. Issuance of euro-denominated bonds on international markets accounted last year for $602 billion, or 45% of total international bond issuance. It surpassed the $572 billion, or 42%, of bonds denominated in dollars.

The international press hailed this result as a "triumph" for the euro "as a major player in capital markets." In our view, this "triumph" rather reflected the less than glorious fact that the euro had become the favorite currency for borrowing for the international community, not for investing. What in particular has been inviting the preponderant use of the currency for this purpose is not hard to discern: the widespread perception that the euro is and will remain a weak currency. As we have explained and complained before, those responsible for the euro have done a lot to establish this negative perception in the markets. A weakening currency cries for foreign borrowers, a strengthening currency repels. In other words, euro-weakness became in this way self-reinforcing, and so will its future strength. In essence, the dollar's strength in the past few years has been conditioned by aggressive American borrowing, not by foreign investing. Intrinsically, the domestic borrowing binge has spilled over abroad.

LOOKING FOR ROOT CAUSES

A recent article in the *Wall Street Journal* about the presidential candidates started with the words "Each of the men vying to become U.S. president wants voters to believe that he knows how to keep the good times rolling. Trouble is, none of the experts really know why the American economy is performing so well. 'We are all scratching our heads about this,' says Alan Binder, former vice chairman of the Federal Reserve Board."

Among thoughtful economists, it is now commonly accepted that the booming U.S. economy has developed a variety of large and growing, interrelated imbalances that have the same common cause: unsustainable credit excesses. In so far, it may seem that we have growing company with our critical opinion in this regard. We are, effectively, coming to the most important concern of all: the possible or probable severity of the aftermath when this bubble finally bursts.

Earlier, we mentioned what we regard as the overriding, aggravating factor in this development: the vast

current account deficit. On the other hand, it has to be realized that both this deficit and the strong dollar have played a key role in making this breathtaking wealth creation through the stock market feasible. As to the strong dollar, this is self-evident. The huge import surplus significantly helped to suppress consumer and producer price inflation, while the associated big surplus in the capital account has significantly helped to contain the rise in interest rates. What's more, the low inflation rates gave the Fed the green light for the monetary looseness which, in turn, delivered the fabulous bubble prosperity in the form of skyrocketing stock valuations.

Actually, with a year-on-year rise in consumer prices by 2.7%, America has the highest inflation rate among the industrial countries, comparing with an average increase in Euroland by 1.5%. Yet it's the higher American rate that enjoys the greater admiration in the markets, owing to the fact that it has fallen against the headwinds of very strong economic growth, a very tight labor market and rising wages.

The flaw in this perception is that it completely ignores the heavy anti-inflationary impact of the strong dollar and the ballooning U.S. trade deficit. What happens in the first instance is that the trade deficit makes goods available to the American public vastly in excess of domestic output. Given the phenomenal size of this deficit, running recently at an annual rate of $360 billion, this huge addition to the supply of goods essentially exerts a massive deflationary influence on the U.S. domestic price level. Not only that. In the second instance, the deficit drains the U.S. domestic money supply. Payments for the import surplus transfer a correspondingly huge amount of money balances to foreigners. And what does that have do with the money supply? In the last years, they have readily recycled all this money into the U.S. economy. But the important thing to see is that this dollar recycling takes place through the capital account into the U.S. financial markets.

Perplexingly, the dollar deluge from the U.S. consumer borrowing and spending binge that fuels the monstrous trade deficit ultimately ends up as foreign dollar savings in the U.S. financial markets helping to keep them booming which, in turn, helps to fuel the consumer borrowing and spending binge. Considering the phenomenal sums involved, there can be no doubt that this sequence of soaring flows and effects, intrinsic to the strong dollar and the exploding trade deficit, has been of overriding importance in creating the delusion of wonderful, new prosperity. Certainly, the two (the strong dollar and the huge trade deficit) have been and remain, in fact, the indispensable condition for this "virtuous" circle that has served not only the United States but the whole world so very well in the past few years. The Americans spend, and the rest of the world produces and delivers the necessary goods against some scraps of U.S. paper.

SOFT OR HARD LANDING

Watching this plainly absurd development reminds us again and again of a remark by Ludwig von Mises about the supreme necessity to distinguish between short run effects and long run consequences of economic changes or measures: "It may sometimes be expedient for a man to heat the stove with his furniture. But if he does, he should know what the remoter effects will be. He should not delude himself by believing that he has discovered a wonderful new method of heating his premises."

Is the incredible rise in stock prices since 1995 the reflection of real wealth created in the American economy, or is it merely a financial bubble that is bound to burst sooner or later? Is this really the second Industrial Revolution that will bring the greatest prosperity of all time? Let there be no doubt, what we are witnessing is history's greatest financial bubble fed by history's most reckless and most careless credit excesses. Accordingly, the economic and financial imbalances that have accumulated are also of unique magnitude in history.

No one knows how much longer a mania will last and how much further it may go. But history holds two lessons in this respect: *first,* credit excesses inherently sow the seeds of their later bust, and *second*, the length and severity of the following "adjustment crisis" depend largely on the magnitude of the prior credit excesses and the associated imbalances that they have created in the economy and the financial system.

But if little can be said about the timing of the inevitable bust, quite a lot can be said, based on economic theory and historical experience, about the severity of the aftermath. From what we had occasion to read recently in this regard, the general hope even of people who are by no means blind adherents to the new paradigm fable is for a soft landing, implying a substantial correction in the stock market, a fall of the trade-weighted dollar by perhaps 5-10%, mild upward pressure on U.S. inflation, a moderate rise in U.S. interest rates, substantial shrinkage of the U.S. current account deficit but no serious damage to the U.S. economy. In other words, no recession, or at worst, light and brief recession. Decisive assumptions underlying this benign scenario, widely expected, are a few further rate hikes by perhaps 0.5% or at most 0.75% and accelerating economic growth in the rest of the world.

IF EVER....

Very probably, quite a few people will regard this prediction exceedingly pessimistic. We find it highly optimistic. What strikes us most strongly is a general complete disregard of the serious complications and aggravations that loom for the U.S. economy in the mammoth U.S. current account deficit and at the currency front.

Global, unreserved confidence in a strong dollar has been an indispensable, most important condition in fostering the Wall Street mania. The dollar's pronounced weakness against the yen is simply discarded as isolated yen strength, yet it certainly warns of unforeseeable trouble at the currency front. If ever this confidence in the currency is shaken, it is sure to pull the rug from under the whole America bubble economy by disrupting the flows that finance the gaping current-account deficit. Taking the monstrous size of that deficit and the even more monstrous size of the accumulated net foreign indebtedness (now more than $ 1.5 trillion) into account, it should be realized that this embodies potential catastrophe for the United States and the whole world. All it needs to rock the dollar are minimal reversals in the current flows.

There is wide unbounded faith that if ever the stock market and the economy should seriously falter, Mr. Greenspan would quickly slash interest rates to whatever low levels may appear necessary and "print money." Since those two events would unquestionably be accompanied by a weakening dollar, it is, however, more than doubtful that he can promptly respond, let alone with major rate cuts. The fact that the deficit has been ignored for years should not make believe that such unconcern is for eternity under all circumstances. Any small event, not yet foreseeable, may all of a sudden inflame the powder keg. That's why careful policymakers have always strived to avoid the accumulation of such powder kegs, conventionally known as "imbalances."

A falling dollar will essentially involve two further effects that will additionally tend to impair the splendid image of the new paradigm economy. That is, it will put upward pressure on U.S. inflation rates and interest rates. To be sure, the unfolding recession will unleash forces to lower both of them, but we think that this influence will be more than offset by the impending dramatic reversal in the capital flows and of the dollar against the euro. In this light, we easily see a steep decline of the dollar against the euro by 20-30%, with U.S. inflation rates rising above 3% and long-term Treasury yields heading to around 8% and higher. Correspondingly, this implies lower inflation and interest rates in Euroland.

The fact is that the yawning gap in foreign trade and the U.S. economy's foreign indebtedness are now of

such stupendous proportions that any comparisons with the past or any attempt to quantify the ultimate impact of the bursting of this bubble appear extremely hazardous. But it's safe to say that with their potential adverse effects on the dollar, the trade deficit and the accumulating foreign indebtedness are the paramount threat to the stability of the whole U.S. economy with immeasurable, potential implications for the world economy.

We expect that Mr. Greenspan will continue to avoid any true monetary tightening. The easiest way and also the best recipe to avoid any blame is always to act in accordance with prevailing public opinion. Wall Street opinion wants interest rate hikes from him that don't hurt. He will deliver, but the runaway credit boom will put increasing pressure on market yields.

While keeping in mind that private household savings have dwindled to insignificance, think about the following statement (and the financial and economic ramifications) from Charles Schwab's recently released fourth quarter report:

"Our customers brought a record $33 billion in net new assets to the firm during the fourth quarter, which pushed net new assets for the year to $107 billion, up 35% from last year. Net new assets per new account equaled $40,000 during the fourth quarter, up 18% from the same period last year. Customers opened a total of 1.5 million new accounts during the year, and we had 6.6 million active accounts by the end of 1999. We crossed the $700 billion in customer assets during December, and ended the year with $725 billion in customer assets, an increase of $234 billion over the year-end of 1998." N.B. personal savings totaled a $199.4 billion last year.

CONCLUSIONS:

The strong dollar and the ballooning U.S. current-account deficit have played a crucial role in fostering the American "new paradigm mirage." But running out of control, the deficit has become the greatest threat to the economy, the financial markets, and the dollar. With a sharply weaker dollar, the "American model" will quickly be a thing of the past.

A continuing global recovery implies flows out of the United States into other recovering regions. Yen and euro will both rise against the dollar. Yet, the biggest threat is the euro. Europe's economy is far stronger than that of Japan and after the U.S. economy the largest in the world. Yet the favorable fundamentals of the euro may for some time still be blurred by special factors such as new paradigm thinking and overblown bearish sentiment.

A sharp fall of the dollar against the euro is the nightmare of European policymakers. They have done and still do their best to keep the euro weak by publicly downgrading the importance of the exchange rate.

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